"Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?"

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Kenneth Rogoff

My Computer.lnk Thomas D. Cabot Professor of Public Policy
and Professor of Economics, Harvard University[1] and
Visiting Fellow, Brookings Institution

[1] Kenneth Rogoff, Department of Economics, Littuaer Center 232, Harvard University, Cambridge MA 02138-3001; Phone: 617-495-4022, Fax: 617-495-7733; krogoff@harvard.edu, http://www.economics.harvard.edu/faculty/rogoff/rogoff.html

With the United States running a current account deficit at 6 percent of national income, foreign nationals have been accumulating U.S. assets at a spectacular rate. Taking into account recent stock market gains, foreigners now hold well over $14 trillion of U.S. assets, more than a 100% of U.S. gross domestic product. Foreigners, mainly foreign central banks and government investment funds, hold more than $2.5 trillion in U.S. Treasury securities alone. Incredibly, the United States absorbs roughly 70 percent of all net saving produced by the world's current account surplus countries, including China, Japan, Germany and the oil exporting countries. Borrowing on this scale by any large country, much less the world's pre-eminent economy is unprecedented in modern world history.

Many observers are asking whether U.S. indebtedness to foreigners might pose any subtle hidden threats to the U.S. economy or, even to U.S. national security. With China alone holding $1.2 trillion in reserve assets and foreigners collectively holding more than twice that in U.S. Treasury securities, is there any risk that the United States might be subject to economic blackmail? What about the rapid proliferation of so-called sovereign wealth management funds, most famously China's $3 billion investment in the private equity group Blackstone? Sovereign wealth funds now control nearly $2 trillion in assets, more than stand-alone hedge funds. Is there a risk that foreign governments will use their financial relationships to compromise U.S. security? Is there any danger of exotic "Goldfinger"-like scenarios where foreign governments might use their massive leverage to precipitate a wholesale financial collapse in the United States?

The short answer is these more extreme risks are unlikely to materialize, but the United States continued dependence on foreign borrowing is a significant vulnerability in the event of shock, such as a collapse in US housing prices, or an extreme national security breach, that might slow the inflow of new funds into the United States. In this testimony, I will first discuss why the more extreme scenarios are relatively implausible, then go on to discuss where the real vulnerabilities lie.

When a Debtor is Big Enough, it's the Banks' Problem: The United States and China

As foreign wealth continues to explode in a number of transparency-challenged countries, we are likely to see some spectacular financial debacles. Governments have a long tradition of losing massive amounts of money in financial markets. This tradition is not likely to end anytime soon, which is good new for global private investors, some of whom continue to reap huge profits at governments' expense. However, any attempt by a well-heeled foreign government to use its financial leverage to upset the US economy will almost certainly backfire. The US economy will not wilt, and the foreign instigator will either lose a bundle of money immediately, or get caught and be forced to forfeit the gains. The key to U.S. resilience is our country's credibility in debt markets; the U.S. governments' credibility in international debt markets is so great that it is virtually impossible for any such crisis to precipitate a default. Absent, this risk, it is very unlikely

for a foreign-instigated financial crisis to spin beyond the control of the Federal Reserve and other regulators.

For example, were China to suddenly reallocate a large share of its predominantly dollar portfolio into Euros, the ensuing dollar decline would inflict a massive capital loss on the Central Bank of China. A 20 percent drop in the dollar against the Yuan would cost the Chinese Central Bank well over a hundred billion dollars. Fundamentally, when a debtor owes the bank a large enough amount, the debt becomes the bank's problem. China, whose reserves amount to 50 percent of its GDP, faces risks far to great to ever seriously consider this option. Of course, over time, one can expect China to significantly diversify out of dollar assets, but the time frame will be one that markets can easily accommodate.

Risk posed by Sovereign Wealth Funds

One should entirely dismiss the risks posed by the recent trend towards riskier investment strategies by sovereign investors, notably the so-called "sovereign wealth funds." With deep pockets and the potential to draw on vast credit lines, sovereign wealth funds can potentially take larger and more leveraged risk positions than even the most aggressive private hedge funds. Given many of these funds weak governance and lack of transparency, global regulators are rightly concerned that one of these funds may precipitate a significant financial crisis. An ill-considered massive bet by a sovereign wealth fund, or perhaps the actions of a rogue trader within a sovereign wealth fund, could cause a massive price fluctuation in a financially-sensitive part of the global economy. Here again, however, the big loser would be the government that owned the sovereign wealth fund, and would ultimately have to foot the bill for a catastrophic loss. True, there could be substantial collateral damage as in international financial crisis, but again, given the solid fundamentals of the U.S. financial system, prompt response by regulators and the Federal Reserve should be able to contain the problem.

Goldfinger Risk

Yes, one can imagine more far-fetched and devious schemes to upend the global financial system. In the James Bond movie "Goldfinger," the villain aims to bid up the value of his own gold holdings by irradiating the gold in Fort Knox, thereby cornering the market. In the real world, the Hunt brothers were accused of cornering the futures market in silver in the early 1980s. Given today's spectacular explosion in global financial assets, it is easy to imagine financial fraud and crime surpassing all previous benchmarks. Yet, in the scheme of things, deeper financial markets probably make things safer not riskier. It is far harder to corner a commodities market today than it was twenty five years ago. Rather than resisting financial globalization, the right approach is to continue to promote better corporate governance at home, and greater transparency on the part of financial entities, including sovereign wealth funds. In pursuing these goals, the United States should continue to work closely with multilateral agencies such as the International Monetary Fund or the Bank for International Settlements.

The United States is a Big Winner from Financial Globalization

In contemplating any policy actions, it is important to recognize that the United States is a massive winner from financial globalization. Although it is true that the United States is a large net debtor (with roughly $3 trillion in net debt), the cost to the United States has been relatively modest because, on average, Americans have earned a significantly higher return – about 1.5 percent higher – on their holdings of $10 trillion in foreign assets than foreigners have earned on their holdings of $13 trillion in U.S. assets. This differential has met that U.S. net debt accumulation has been significantly less rapidly than our $800 billion trade balance deficit might suggest, typically half as much. U.S. financial firms are the envy of the world, they arguably constitute the United States' most successful export industry. Any attempt to block foreign entities from engaging in the United States could lead to retribution that backfires and hurts U.S. interests.

Although a Simpler, Fairer Tax System is Needed

Of course, this does not mean that US should give privileged tax treatment to hedge funds and private equity any more than it should give better treatment to other export or import-competing industries. But a patchwork fix could prove highly counterproductive. Faced with the rapidly changing winds of globalization, the United States needs -- now more than ever -- a much cleaner and simpler tax system. A flat tax with a large exemption at low incomes would likely prove far fairer and more efficient in practice than the current labyrinth of taxes.

The Massive United States Current Account Deficit Still Poses Real Vulnerabilities that should be Addressed

I have argued that growing international indebtedness does not seriously expose the United States to any of the more extreme doomsday scenarios. This is not to say that we should greet the US current account deficit with equanimity. It is a significant vulnerability that could significantly amplify the effects of growth crisis precipitated either by economic factors (say, a historic collapse in housing prices), or geopolitical factors (a terrorist attack of unprecedented dimensions on U.S. soil.) If the United States were forced to cut back the flow of its new borrowing by say, a half – to $400 billion per year, the trade-weighted dollar could easily fall 20-25 percent, and interest rates could rise by close to one percent across the board.[2] On impact, it is quite possible that financial markets would overshoot.

Thus, in a crisis, the United States' position as a big net borrower could prove an Achilles' heel that considerably amplifies the magnitude and duration of a crisis. Although this risk has not materialized even after years of very high US deficits, it remains a concern. Policies to raise US public and private savings would be a helpful step towards ameliorating these risks. So, too, would be more flexible exchange rates in Asia and a greater reliance on domestic demand for growth in Europe. Coordinated

[2] For calibrations on how a closing up of the US current account might affect the trade weighted US exchange rate, see Obstfeld and Rogoff (2005, Brookings Papers on Economic Activity, and 2007, National Bureau of Economic Research.)

policies have been advanced by the International Monetary Fund for many years now, though with relatively little traction, especially in China but also in the United States. While it is true that US current account is showing signs of stabilizing this year, the "soft landing" scenario will take at least a decade to fully materialize, leaving the U.S. vulnerable to a "hard landing" scenario in the interim.

In sum, the United States, with its superior legal system and transparency, is a big winner in financial globalization. Integration of global financial markets has helped lead to lower interest rates and a more stable US economy. Foreign investment in the United States has to be viewed in the context of the larger picture, which takes into account the enormous success of U.S. investors abroad. Doomsday scenarios, while theoretically possible, seem remote. However, although these extreme risks are remote, the United States massive dependence on foreign borrowing remains an important vulnerability. Any global macroeconomic or geopolitical shock that leads to a sharp contraction of the US current account deficit is likely to produce a massive dollar drop, and possibly a sharp interest rate rise, that would considerably amplify the adverse effects of the shock on the U.S. economy. It would be far better to take steps to gradually close up the United States massive borrowing gap than to wait for such a crisis.

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